1982

Much Ado about Due-on-Sale: Avoiding the Tempest in New York

Linda L. Kreicher

Follow this and additional works at: http://scholarlycommons.law.hofstra.edu/hlr

Part of the Law Commons

Recommended Citation
Available at: http://scholarlycommons.law.hofstra.edu/hlr/vol10/iss4/10

This document is brought to you for free and open access by Scholarly Commons at Hofstra Law. It has been accepted for inclusion in Hofstra Law Review by an authorized administrator of Scholarly Commons at Hofstra Law. For more information, please contact lawcls@hofstra.edu.
MUCH ADO ABOUT DUE-ON-SALE: AVOIDING THE TEMPEST IN NEW YORK

I. INTRODUCTION

Today's ubiquitous due-on-sale clause, either buried in or missing entirely from residential mortgage contracts prior to 1970, has emerged from obscurity to spark litigation across the country. Heralded as the salvation of lenders and the nemesis of borrowers, the due-on-sale issue is central to today's rapidly evolving era of banking and real estate law. The issue of the clause's validity and enforceability has been the subject of numerous cases in both state and federal jurisdictions. State and federal legislatures have introduced bills seeking to limit or uphold its enforceability. The picture is further complicated by the diverse practices and procedures of the country's dual banking system and the various regulatory agen-

1. A due-on-sale clause, used in real property security transactions such as home mortgages, provides for acceleration of the loan principal, at the option of the lender, in the event of transfer, sale or further encumbrance of the property. G. Osborne, G. Nelson & D. Whitman, Real Estate Finance Law 295 (2d ed. 1979) [hereinafter cited as G. Osborne]; see infra note 10 and accompanying text.
4. See infra notes 79-99 and accompanying text.
5. See infra notes 158-91 and accompanying text.
6. The dual banking system refers to the regulatory structure of the lending institutions which may be regulated by both state and federal agencies. For example, savings and loan associations may be either state or federally chartered. G. Osborne, supra note 1, at 641. The Federal Home Loan Bank Board (FHLBB), an independent agency established under the Federal Home Loan Bank Act of 1932, 12 U.S.C. § 1437(a) (1976), has authority to charter and regulate the federal savings and loans (FS&Ls) under the Home Owner's Loan Act of 1933 (HOLA), 12 U.S.C. §§ 1461-70 (1976). The state chartered savings and loan associations (SS&Ls) are partially controlled by the FHLBB by virtue of the state associations' membership in such federal insurance programs as the Federal Savings and Loan Insurance Corporation (FSLIC). G. Osborne, supra note 1, at 641. SS&Ls are, however, under the authority of state banking boards, which control their lending and operational activities. This dual system "produces some interesting and arguably irrational distinctions" in the permissible activities of the associations. Id. at 642. For example, prior to 1979, FS&Ls were not permitted, under FHLBB regulations, to make variable rate mortgages while a number of state-chartered institutions could do so. Id. In fact, when FS&Ls were authorized to make adjustable rate mortgages, the New York Banking Department took emergency action to give state-chartered insti-
cies which supervise the functioning of the lending institutions in the area of residential loan financing.

The spirited controversy about the due-on-sale clause in mortgage contracts is a natural by-product of the economic conditions which affect both borrowers and lenders in today's money market. With interest rates towering at unprecedented levels and inflation substantially raising the prices of homes, the average consumer is more aware than ever of the intricacies and issues involved in mortgage financing. Likewise, lenders are finding it increasingly necessary to protect their loan portfolios by employing options, such as enforcement of the due-on-sale clause, which allow them to reassess the return rate on their investments. The due-on-sale provision in the mortgage loan contract typically provides that if the subject property is sold, conveyed, transferred or otherwise alienated from the original owner, without the prior consent of the lender, the lender reserves the right to accelerate the remaining balance of the loan as

Regulation of commercial banks, both state and federal, is more complex than that of the savings and loan associations or mutual savings banks. G. OSBORNE, supra note 1, at 642. Commercial banks' more diverse activities are supervised by several federal agencies in addition to their home state's banking boards and regulations. Id. at 643. Federally chartered commercial banks (called "national banks") are governed by the Federal Reserve Board and the rules and interpretations issued by the United States Treasury, Office of the Comptroller of the Currency (OCC). Id. Those state-chartered banks that are members of the Federal Reserve system are also governed by the Federal Reserve Board. Id. Those state banks that are not members may still have their deposits insured by the Federal Deposit Insurance Corp. (FDIC) which also insures and supervises national banks. Id. The real estate lending activities of state-chartered commercial banks, however, are subject only to regulation by their state banking boards and state law. Id. at 644. Despite the greater complexity of the commercial banks' regulatory scheme, both state and federal commercial banks are usually able to exercise greater discretion in real estate lending than the savings and loan associations. Id.

Mutual savings banks are exclusively state-chartered, but exist in only eighteen states. Their lending activities extend to commercial and residential mortgage loans. They are regulated by the state's banking board but also subject to the applicable FHLBB's regulations if their deposits are insured by the FSLIC. Id.

See supra note 6.


immediately due and payable. Lenders may also use a due-on-encumbrance clause which accelerates the debt in the event the mortgaged real estate is subsequently encumbered by a junior lien or secondary mortgage.

The consumer battle against the enforceability of the due-on-sale clause has raged ever since interest rates rose high enough to scare off prospective home buyers. A mortgage contract which does not contain a due-on-sale provision can represent an attractive financing arrangement for a prospective purchaser which the seller can parlay into extra cash, upon sale of the home, by raising the purchase price to reflect this added feature. By preventing the

10. For example, the due-on-sale clause in the Federal National Mortgage Association (FNMA)/Federal Home Loan Mortgage Corporation (FHLMC) form provides: "If all or any part of the property or an interest therein is sold or transferred by borrower without Lender's prior written consent . . . Lender may, at Lender's option, declare all the sums secured by this Mortgage to be immediately due and payable." FNMA/FHLMC Uniform Instrument 6175, para.17, quoted in O'Connell, The Due-On-Sale Clause in Florida: A Potential Battleground for Borrowers and Lenders, 31 U. FLA. L. REV. 933, 934 n.9 (1979).

A due-on-encumbrance clause is a variation of the due-on-sale clause, which provides specifically for acceleration in the event the borrower should "dispose of or further encumber said property, or any part thereof, or any interest therein. . . ." See LaSala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 869, 489 P.2d 1113, 1115, 97 Cal. Rptr. 849, 851 (1971).

Some mortgages also contain a provision to allow the lender to collect a prepayment charge if the borrower prepays the loan, either as a result of an acceleration clause or to refinance if interest rates fall. See Comment, Debtor-Selection Provisions Found in Trust Deeds and the Extent of Their Enforceability in the Courts, 35 S. CAL. L. REV. 475, 475 n.2 (1962).


12. The residential mortgage rate in New York (Nassau County) in November 1981 was 17.5%. In addition, there was a 3-point loan servicing fee—a one-time charge based on 3% of the borrowed principal. N.Y. Times, Nov. 22, 1981, (Long Island Section), at 33, col. 1; see supra note 8. The problem can be illustrated by examining a typical residential real estate transaction: In 1970, A buys a home for $60,000 with a $10,000 down payment, securing a loan for $50,000 from a lending institution at eight percent interest for a thirty-year term. Assume mortgage interest rates remain relatively stable over the next five years and, in 1975, A sells her home to a purchaser, B, for $80,000. A's mortgage contract, with its remaining twenty-five-year term, has an enforceable due-on-sale clause which allows the lender to accelerate the principal at the time of sale. Alternatively, the lender can waive the acceleration in exchange for a renegotiated rate of interest on the mortgage assumed by B. This due-on-sale clause effectively prevents A from selling her home and her interest rate of eight percent to B. If the lender refuses to allow transfer at the old rate, B has to obtain a new loan, with either the same or a different lender, at the prevailing market rate. If the interest rate change is minor, neither A nor B contests the enforceability of the due-on-sale clause or its effect on the transaction. If the sale takes place in 1981, however, the change to the prevailing market rate could result in a significant increase in the monthly interest payments which B must make to the lender thereby dramatically increasing B's overall costs. This situation could preclude B's purchase of the property, increasing A's interest in litigating to avoid the lender's enforcement of the clause.

13. The purchaser of an assumable mortgage may pay a premium of five to ten percent
transfer of the old interest rate to the new buyer, however, the lender has the power to use the due-on-sale clause as an interest-increasing device for its loan portfolio during periods of volatile interest rates.

The use of the due-on-sale clause by the lender to protect mortgage loan portfolios through maximization of interest rates on transferred loans is well known in the mortgage lending industry. Judicial review of the clause, however, tends to focus primarily on its use as a device to protect against impairment of the lender's security. While security protection should not be ignored, the courts' focus on this single justification has contributed to the demise of the due-on-sale clause in circumstances where the lender, under the imposed burden of proof, is unable to demonstrate a threat to security sufficient for the courts to sanction its use.

The issue of the due-on-sale clause's enforceability is important to the national mortgage market because the cost of a home represents a significant outlay for the average homeowner. Likewise, private institutional lenders, which include commercial banks, mutual savings banks, state-chartered savings and loan associations (SS&Ls), and federally chartered savings and loan associations above the purchase price of a comparable home without assumable financing. This represents a windfall to the seller that is subsidized by new borrowers paying higher rates and represents a loss to those who invest in lending institutions. Letter from Robert L. Kemper, Pres., California Bankers Association to Office of the Comptroller of the Currency, Washington, D.C. (Nov. 25, 1981) (commenting on the proposed rule for national banks regarding due-on-sale clauses) (copy on file in office of Hofstra Law Review); see infra text accompanying notes 146-56.

14. The due-on-sale clause is not self-executing but allows the lender the option to accelerate, within a reasonable time following transfer, or to waive the option in exchange for the payment of transfer fees or an increased interest rate. See Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 304, 509 P.2d 1240, 1246 (1973) (one month is reasonable, but not one year); Dunham v. Ware Sav. Bank, Mass. 423 N.E.2d 998, 1000 (1981) (three months after transfer not unreasonable delay before acceleration, but "once the bank knows or should have known of the transfer, any delay is at its peril").


17. Comment, supra note 10, at 482.


(FS&Ls), have a huge stake in the mortgage market. Because savings and loans associations are the major source of residential loan financing, their interest in the controversy is considerable and, in fact, substantial litigation of the issue has involved savings and loan associations' use of the due-on-sale clause.

This note assesses the current state of the law nationally as to the validity of the due-on-sale clause in residential and commercial loan contracts with some focus on the California case law that has precipitated or influenced litigation in other states. The note examines the federal attempt to preempt contrary state law on the subject of due-on-sale clauses and develops a rationale for their continued use in loan financing agreements in light of recent changes in national banking and loan financing regulations. Finally, the note explores the status of the due-on-sale clause in New York mortgage instruments and proposes a more definite judicial and legislative endorsement.

II. BACKGROUND OF THE DUE-ON-SALE CONTROVERSY

A. The California Influence

The California Supreme Court's now famous Wellenkamp v. Bank of America decision, which limited state lenders' enforcement of due-on-sale clauses, evolved from an earlier line of California cases that first sanctioned the use of the clause. In Coast Bank v. Minderhout the California court allowed an institutional lender to enforce a loan provision that restricted the borrower's right to encumber certain real estate used as security for the loan until the indebtedness was paid. The court concluded that it was not an unreasonable restraint on alienation, and consequently not in violation of a California common-law rule that prohibits invalid restraints on alienation, for the bank to condition its continued credit on the bor-
rower's agreement not to encumber or transfer the property. The court, in effect, gave its blessing to the due-on-sale or encumbrance arrangement, noting that certain restraints were reasonable when "designed to protect justifiable interests of the parties." 28

Following this decision, the lender's use of the due-on-sale clause received appellate court endorsement in *Hellbaum v. Lytton Savings & Loan Association of Northern California* 29 and *Cherry v. Home Savings & Loan Association.* 30 In *Cherry,* the court noted the lender's use of the due-on-sale clause to defend against the risk of an unreliable new purchaser and also commented favorably on the use of the clause as a device to increase interest rates upon transfer:

> When interest rates are high, a lender runs the risk they will drop and that the borrower will refinance his debt elsewhere . . . . [W]hen money is loaned at low interest, the lender risks losing the benefit of a later increase in rates. [A] due-on-sale clause is employed . . . so that he may take advantage of rising interest rates in the event his borrower transfers the security. This is merely one example of ways taken to minimize risks by sensible lenders. There is no inequity visible from such a provision. 31

Following *Cherry,* however, the California Supreme Court progressively restricted the use of due-on-sale clauses in lending instruments. In *LaSala v. American Savings & Loan Association,* 32 the court, in a class action suit, considered a bank's use of a due-on-encumbrance clause in its mortgage instruments. The bank sought to enforce the clause against co-plaintiffs who had each borrowed money, secured by second mortgages on their homes, from a private lender. 33 The bank agreed to waive their option to accelerate the mortgage principal if the homeowners agreed to a $50 and $150 fee, respectively, and an interest rate increase on the outstanding loan principal. 34 The court acknowledged that protection of the lender's

---

28. *Id.* at 316, 392 P.2d at 268, 38 Cal. Rptr. at 508.
33. *Id.* at 868-69, 489 P.2d at 1115, 97 Cal. Rptr. at 851.
34. *Id.* at 870, 489 P.2d at 1116, 97 Cal. Rptr. at 852.
security justified automatic enforcement of due-on-sale clauses because the sale of property divests the original borrower of any interest in the property and the shift in responsibility for the property's upkeep could increase the lender's risk.\textsuperscript{35} The court refused enforcement of the due-on-encumbrance clause, however, because the junior encumbrance did not divest the owner's interest or increase the lender's risk.

Balancing the clause's restraining effect on alienation against the degree of risk to the lender, the \textit{LaSala} court held that the use of the clause unlawfully restrains alienation whenever the junior encumbrance does not endanger the lender's security.\textsuperscript{36} The court did not feel constrained by the earlier decisions in \textit{Coast Bank} and \textit{Hellbaum}, noting that the discussion of due-on-encumbrance clauses by those courts was dicta.\textsuperscript{37}

The \textit{LaSala} balance of interests approach was broadened in \textit{Tucker v. Lassen Savings \\& Loan Association}.\textsuperscript{38} Declining to uphold a due-on-sale clause in a land installment sale, the court held that allowing the lender to accelerate the loan would unreasonably restrain the sale.\textsuperscript{39} The court reasoned that the borrower-seller in an installment contract, normally receives only a fraction of the purchase price at the time of transfer and, therefore, would not have the means to pay the lender the outstanding debt. The installment sale thus differs markedly from an outright sale where the entire price is paid upon transfer. Moreover, the risk to the lender is considerably lessened under an installment sale since the borrower retains legal title and thus has an incentive to maintain the property's value until the full price is paid.\textsuperscript{40} The \textit{Tucker} court examined the practical effect upon alienation—the "quantum of restraint"—that would result from enforcement of the due-on-sale clause.\textsuperscript{41} It concluded that the clause could only be validly enforced if the lender demonstrated a sufficient threat to justify the considerable restraint

\begin{footnotesize}
\begin{enumerate}
\item Id. at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859.
\item Id. at 877, 489 P.2d at 1121, 97 Cal. Rptr. at 857. The court did recognize, however, that a junior lien could, under certain circumstances, justify acceleration. The key element in the situations listed by the court was that the borrower's remaining interest did not provide sufficient incentive to avoid waste or depreciation. Comment, Wellenkamp v. Bank of America: A Victory for the Consumer? 31 HASTINGS L.J. 275, 279 (1979).
\item LaSala, 5 Cal. 3d at 879, 489 P.2d at 1122, 97 Cal Rptr. at 858.
\item 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).
\item Id. at 637-38, 526 P.2d at 1174-75, 116 Cal. Rptr. at 638-39.
\item Id.
\item Id. at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637.
\end{enumerate}
\end{footnotesize}
and held that, under the facts, the lender had not done so.\textsuperscript{42} The court also rejected the argument that increasing the lender’s interest rate justified the clause’s enforcement in an installment sale, but added that it did not address whatever “cogency [the] argument [might] retain concerning the relatively mild restraint involved in the case of an outright sale.”\textsuperscript{43}

\textit{Tucker} and \textit{LaSala} clearly evidenced an erosion of the automatic application of due-on clauses. This trend was advanced by the application of these principles in the California Supreme Court’s landmark decision in \textit{Wellenkamp v. Bank of America}.\textsuperscript{44} In \textit{Wellenkamp}, the plaintiff had agreed to purchase residential property and to assume the seller’s loan obligation. The loan agreement contained a standard due-on-sale clause which the lender agreed to waive in exchange for a 1¼% increase in the loan’s annual interest rate. The plaintiff refused this demand and sought an injunction against the lender’s enforcement of the clause and a declaration that, since the lender’s security was not imperiled by the sale, enforcement of the clause constituted an unreasonable restraint on alienation.\textsuperscript{45}

The \textit{Wellenkamp} court determined that a restraint asserted by a due-on-sale clause had a prohibitive effect on the property sale where the lender’s potential refusal to allow assumption of the old interest rate in a tight money market would result in the buyer’s inability to secure new financing. Likewise, if the lender only agreed to the loan assumption at an increased rate, the sale could still be inhibited by the buyer’s demand that the seller lower the purchase price or forego the sale. In either case, according to the court, there resulted a clear restraint on alienation\textsuperscript{46} that outweighed the purported justification for enforcement of the clause.\textsuperscript{47} The court concluded that outright sale of the property did not necessarily increase the lender’s risk that waste or default would occur when the new buyer could be as financially sound as the original borrower, if not

\begin{itemize}
\item \textsuperscript{42} Id. at 639-40, 526 P.2d at 1175-76, 116 Cal. Rptr. at 639-40. The court did note, however, that a due-on-sale clause could be enforced in an installment sale context if a legitimate threat was shown, i.e., if the lender demonstrated that the conduct of the party in possession under the land contract would cause waste or depreciation or increase the likelihood of default. \textit{Id.} at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639.
\item \textsuperscript{43} Id. at 639 n.10, 526 P.2d at 1175-76 n.10, 116 Cal. Rptr. at 639-40 n.10.
\item \textsuperscript{44} 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).
\item \textsuperscript{45} Id. at 946-47, 582 P.2d at 972, 148 Cal. Rptr. at 381.
\item \textsuperscript{46} Id. at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383-84.
\item \textsuperscript{47} Id. at 952, 582 P.2d at 975-76, 148 Cal. Rptr. at 385.
\end{itemize}
more so. This reasoning represented a departure from LaSala and Tucker where the distinction that seller retained title was determinative as a measure of the risk.

Wellenkamp also specifically rejected the argument that protection of the lender’s mortgage portfolio warranted the rate increase given the quantum of restraint imposed on the seller. In fact, the court took the position that the use of the due-on-sale clause was an unjust attempt by the lender to transfer onto the borrower the economic risks of an inflationary economy. Justice Clark, the lone dissenter, suggested that the restraint on alienation effect did not result from the due-on-sale clause, but rather from the inflationary economy’s tight money market. He also criticized the majority’s failure to recognize that “lenders and borrowers . . . and prospective owners, should be allowed to run their own affairs with minimal governmental intrusion—particularly from [the judiciary]” and predicted that such interference would hinder the availability of mortgage funds for the next generation of borrowers. Despite his vigorous dissent, the Wellenkamp decision “mark[ed] the end of a ten year transition in California law from automatic enforcement to limited enforcement of the due-on-sale clause,” and virtually redesigned the traditional supply-demand model that regulates the economics of the home financing market.

Six months later, in Medovoi v. American Savings & Loan Association, Wellenkamp’s dissenting view was reiterated by the ma-

48. Id.
49. See supra text accompanying notes 32-43.
50. “Lenders . . . take into account their projections of future economic conditions when they initially determine the rate of payment and the interest on these long-term loans. . . . We believe, however, that it would be unjust to place the burden of the lender’s mistaken economic projections on property owners. . . .” 21 Cal. 3d at 952-53, 582 P.2d at 976, 148 Cal. Rptr. at 385.
51. Id. at 956, 582 P.2d at 978, 148 Cal. Rptr. at 387 (Clark, J., dissenting).
52. Id. at 958, 582 P.2d at 980, 148 Cal. Rptr. at 389 (Clark, J., dissenting).
53. Id. at 954, 582 P.2d at 977, 148 Cal. Rptr. at 386 (Clark, J., dissenting).
54. O’Connell, supra note 10, at 943.
55. For a discussion of the economic impact resulting from restriction of the due-on-sale clause’s use, see infra text accompanying notes 206-41. See generally Finch, Due-On-Sale Clauses in Debt Instruments: Reconciling Legal Doctrine and Market Realities, 98 BANKING L.J. 300 (1981).
56. 152 Cal. Rptr. 572 (Cl. App. 2d Dist. 1979). In denying a hearing, the California
and concurring opinions in a California District Court of Appeals decision where the second district court allowed enforcement of a due-on-sale clause involving business property. The court construed the Wellenkamp restriction as expressly limited, not only to institutional lenders, but also to the voluntary transfer of owner-occupied residential property.

Following this, however, the fourth district appellate court in California expanded the scope of Wellenkamp to include private lenders. In Wilhite v. Callihan, the court observed that the issue of whether a property transfer impaired the lender's security was not determined by the lender's status as an institutional or private lender, and held that the lenders, in this case, had not met their burden of justifying enforcement of the due-on-sale clause. This application of the Wellenkamp rule was recently affirmed by the California Supreme Court when, in a similar case, it reversed an appellate court ruling that had exempted private lenders from the burden of proving security impairment before enforcing a due-on-

Supreme Court ordered that the opinion not be officially published. Id.

57. Id. at 583 n.1.
58. 152 Cal. Rptr. at 584 (Thompson, J., concurring).
59. The property was a multiple-residence apartment building and had been the subject of transfer as a result of a foreclosure sale by the holder of the second mortgage. Id. at 576-77.
60. The court referred to the sale of commercial property involving a business transaction as substantially different from the sale of a family residence which had been singled out for special protection by the legislature and concluded that automatic enforcement of a contractual due-on-sale clause, in the context of the facts, did not constitute a restraint on alienation. Id. at 581.
61. See Wellenkamp, 21 Cal. 3d at 952 n.9, 582 P.2d at 976 n.9, 148 Cal. Rptr. at 385 n.9 (expressly limiting holding to institutional lenders). The lender in Wellenkamp was a state-chartered lender, id., as were all the lenders in cases discussed thus far.
62. 121 Cal. App. 3d 661, 175 Cal. Rptr. 507 (Ct. App. 4th Dist. 1981). The Callihans, private individual lenders, made a cash loan in exchange for a second deed of trust encumbering the borrowers' residence. The balance due at the time of the default was $2,133.
63. Id. at 667, 175 Cal. Rptr. at 511.
64. The court, adopting the findings of the trial court, reasoned that the debt owed to the lender was nominal compared to the appreciated value of the house and that the new owner was more creditworthy than the former. Id. at 665, 175 Cal. Rptr. at 510; cf. Garber v. Fullerton Sav. & Loan Ass'n, 122 Cal. App. 3d 423, 176 Cal. Rptr. 49 (1981) (allowing enforcement of due-on-sale clause against buyer who purchased home through tax lien sale). While the Garber court recognized the lack of risk to the lender's security, it concluded that the quantum of restraint imposed was minimal on an involuntary tax lien sale, when the purchaser has no consensual relationship to either the lender or the original borrower and, therefore, no reasonable expectation to have "his purchase financed at a rate of interest grossly below the market rate." Id. at 428, 176 Cal. Rptr. at 53. Had the original borrower sought to sell the property before the tax lien foreclosure, however, he would have had the benefit of the Wellenkamp rule to better realize his equity in the home. Id. at 427 n.2, 176 Cal. Rptr. at 52 n.2.
sale clause.\textsuperscript{65}

\section*{B. Other Jurisdictions' Approaches to Due-On-Sale}

While no state has challenged the fundamental validity of due-on-sale clauses,\textsuperscript{66} others besides California have limited their enforceability. The rationales adopted by the limiting jurisdictions view the due-on-sale clause as either an unreasonable restraint on alienation under the circumstances\textsuperscript{67} or as justified only if the lender proves that the security is at risk.\textsuperscript{68}

Other jurisdictions uphold the general validity of the due-on-sale clause as a legitimate contractual provision absent some underlying fraud or inequity.\textsuperscript{69} Certain jurisdictions specifically recognize the use of the clause as a valid market device for the increase of interest rates,\textsuperscript{70} especially when the loan contract gives the borrower the right to prepay the loan without penalty.\textsuperscript{71}

\begin{itemize}
\item \textsuperscript{66} Comment, Mortgages—A Catalogue and Critique on the Role of Equity in the Enforcement of Modern-Day Due-On-Sale Clauses, 26 Ark. L. Rev. 485, 497 (1973). The author reported a 1971 Utah trial court opinion which held the clause invalid as against public policy. This was said to be erroneous, however, by the Utah Supreme Court which affirmed on other grounds. Id. at 497 n.49.
\item \textsuperscript{67} See, e.g., Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 250 N.W.2d 804 (1977) (due-on-sale clause in mortgage was unreasonable restraint on alienation where sole basis for enforcement was lender's interest in maintaining its mortgage portfolio at current interest rates). See generally Volkmer, supra note 15.
\item The rationale used by these courts has been referred to as the "money market rationale" which "recognizes the need of lenders to maintain their loan portfolios at current rates of interest." Finch, supra note 55, at 306.
\end{itemize}
The myriad factual situations preclude generalization as to the due-on-sale clauses' validity in any one jurisdiction, but reference has been made to those which are either "consumer oriented" or "lender oriented," the classification depending on which party bears the burden of proof. Lender oriented jurisdictions (the plurality view) regard the clause as presumptively valid, while the consumer oriented states require the lender to demonstrate affirmatively some security risk resulting from the transfer. Likewise, although a jurisdiction may fall into a lender oriented category, courts do not hesitate to disallow enforcement when such enforcement would be inequitable. All that is clear is that the special facts of each decision must be carefully examined to forecast the policy that will likely apply to a new set of facts.

C. State Legislation on Due-On-Sale

Several state legislatures have enacted laws restricting the enforceability of the due-on-sale clause. One such law, enacted in

73. Id. at 985-89.
74. Id. at 985.
75. Id. at 985-86. Cases in these jurisdictions generally cite, or their rationale can be traced back to, the early California cases which upheld the due-on-sale clause's general validity. See authorities cited supra notes 24-31; see also Annot., 69 A.L.R. 3d 713, 727-31 (1976 & Supp. 1981) (discussing due-on-sale cases).
78. Compare Miller v. Pacific First Fed. Sav. & Loan Ass'n, 86 Wash. 2d 401, 545 P.2d 546 (1976) (allowing lender increase in interest upon transfer where there was specific provision in loan contract to the effect that "[any transfer] shall be deemed to increase the risk of lender, and lender...may declare the entire balance immediately due...or at its sole option may consent to said change in title or occupancy and may increase the rate of said loan not to exceed two percent per annum to compensate for such increased risk." 86 Wash. 2d at 402, 545 P.2d at 547 (italics omitted)) with Bellingham First Fed. Sav. & Loan Ass'n v. Garrison, 87 Wash. 2d 437, 553 P.2d 1090, 1092 (1976) (permitting due-on-sale acceleration of commercial mortgage only after lender satisfied burden of proof as to threat to security) and Terry v. Born, 24 Wash. App. 652, 604 P.2d 504 (1979) (disallowing cancellation of installment land contract which prohibited both transfer of property and prepayment of debt where there was no threat to lender's security and where buyer's forfeiture would result in loss of initial investment and appreciation value). For a discussion of authorities cited and due-on-sale enforceability in Washington see Finch, supra note 55, at 315-17.
79. See IOWA CODE ANN. § 535.8(2)(c) (West Supp. 1982-1983); N.C. GEN. STAT. § 24-10(d) (Supp. 1981); N.M. STAT. ANN. §§ 48-7-1 to -14 (Supp. 1982). The Iowa statute renders void any provision of a residential loan contract that purports to prohibit transfer or to change the interest rate unless the security of the lender is impaired. The statute's annotation cites an opinion by the state attorney general that recognizes the conflict with federal regulations and acknowledges the preemptive effect of the federal law. Op. Atty. Gen. Pope, Jan. 4,
Colorado in 1975 and applicable to instruments executed after that date, prohibits acceleration by the lender unless the new or prospective purchaser is financially unsound. No transfer fees may be exacted greater than one-half of one percent of the outstanding principal and the interest rate may be increased only to a maximum of one percent above the existing rate. The statute, however, is not applicable to commercial property, including multifamily housing projects, nor to lenders not regularly engaged in the business of real estate loans, i.e. purchase money seller-lenders. Due-on-sale clauses in loans executed prior to 1975, however, regardless of when they are transferred, have been upheld by the Colorado court. Moreover, in 1980, the Colorado voters rejected a proposed amendment to the state constitution which would have prohibited due-on-sale acceleration by any lender, absent substantial threat to the se-

---

1980, cited in IOWA CODE ANN. § 535.8(2)(c), at 24 (West Supp. 1982-1983) (annotation). The New Mexico statute, enacted March 1981, prohibits due-on-sale clauses in residential mortgages unless the security would be substantially impaired by the transfer. It has been held to apply to loans made prior to the law’s effective date but assumed after that date. State v. Valley Sav. & Loan Ass’n, ___ N.M. ___, 636 P.2d 279 (1981). The North Carolina statute, amended in 1981, limits an assumption fee to $175 when the original borrower is released from liability and to $100 if the borrower is not released. For a discussion of the 1975 version of this statute and the holding in Crockett v. First Fed. Sav. & Loan Ass’n, 289 N.C. 620, 224 S.E.2d 580 (1976) (upholding right of lender to increase rates upon transfer of commercial property where there were no prepayment penalties), see Note, Real Property Security—North Carolina Deals Mortgagors a Bad Hand, 13 WAKE FOREST L. REV. 490, 502-05 (1977).

80. COLO. REV. STAT. §§ 38-30-165(1)-(5) (Supp. 1980).
81. Id. § 38-30-165(1)(d).
82. Id. § 38-30-165(1)(a).
83. Id. § 38-30-165(1)(c).
84. Id. § 38-30-165(1)(b).
85. Id. § 38-30-165(3), (4) (the exclusion is for HUD lenders who mature the indebtedness on housing projects pursuant to the current regulation of the federal housing administration (FHA)).
86. Id. § 38-30-165(5).
curity, if the original borrowers remained liable on the note.

Utah, in 1981, passed a law that flatly prohibits the use of a due-on-sale clause in residential loans unless the lender proves that a transfer would substantially impair the lender's interest. The statute is applicable to all mortgage agreements, including those in effect prior to the statute's effective date. There are exceptions for lenders who are not in the business of making loans, and for the use of the clause in loans sold to federal agencies in the secondary mortgage market.

States that have no specific due-on-sale legislation have used other laws to support their particular policy on this issue. Some restrict the lender's right to impose prepayment fees, or restrict the amount of the fee particularly if a due-on-sale acceleration or an interest increase is permitted. In Michigan, the state attorney general has ordered the state's FS&Ls to stop enforcing the clause or face civil penalties, contending that their use of the clause violates the state's Consumer Protection Act. As a result, the Federal Home Loan Bank Board (FHLBB) has brought a suit in federal court to bar the attorney general's actions and to seek confirmation of federal preemption of contrary state law.

A Virginia statute allows lenders the use of a due-on-sale provision as long as it is prominently disclosed to the borrower and no prepayment fee is collected if the clause is enforced. Minnesota, which had restricted due-on-sale acceleration, amended its statute after a state court upheld the clause in a commercial transaction. As of 1981, the liberalized statute allows an interest increase, upon

90. Id. § 57-15-2.
91. Id. § 57-15-6.
92. Id. § 57-15-8.5.
93. E.g., NEB. REV. STAT. § 8-355 (Supp. 1981). The statute makes no reference to due-on-sale clauses but grants all lending institutions incorporated under the laws of Nebraska "all rights, powers, privileges, benefits and immunities which may be exercised as of August 30, 1981 by a federal savings and loan association doing business in Nebraska." Id.
III. THE FEDERAL POSITION AND THE PREEMPTION CONTROVERSY

Many state judicial decisions regarding the due-on-sale clause have involved not only state chartered lending institutions but federally regulated lenders as well. This has complicated the controversy in states that have restricted the clause's enforceability either by case law or statute, since such a position is contrary to that asserted by the FHLBB, the federal agency that governs the federal lenders. In fact, the FS&Ls use a uniform mortgage instrument which contains a due-on-sale clause.

Although the FS&Ls are not required to insert due-on-sale clauses in their contracts, they have the power to do so, and the FHLBB has issued formal regulations on this topic. Promulgated in June 1976 and effective as to all borrower-occupied residential mortgages made by FS&Ls after July 1976, these regulations allow

99. MINN. STAT. ANN. § 47.20 subd. 6-6a (West Supp. 1982).
100. See supra notes 6, 67-70.
101. See supra cases cited notes 67-68.
102. See supra notes 79-92 and accompanying text.
103. See supra note 10.
104. 12 C.F.R. § 545.6-11(d)-(g) (1977). The section has been amended and is now codified at 12 C.F.R. § 545.8-3(f)-(g) (1981):

  (f) Due-on-sale clauses. An association continues to have the power to include, as a matter of contract between it and the borrower, a provision in its loan instrument whereby the association may, at its option, declare immediately due and payable sums secured by the association's security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the association's prior written consent. Except as provided in paragraph (g) of this section with respect to loans made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, exercise by the association of such option (hereafter called a due-on-sale clause) shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the association and borrower shall be fixed and governed by that contract.

  (g) Limitations on the exercise of due-on-sale clauses. With respect to any loan made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, a Federal association: (1) Shall not exercise a due-on-sale clause because of (i) creation of a lien or other encumbrance subordinate to the association's security instrument; (ii) creation of a purchase money security interest for household appliances; (iii) transfer by devise, descent, or operation of law on the death of a joint tenant; or (iv) granting of a leasehold interest of three years or less not containing an option to purchase; (2) shall not impose a prepayment charge or equivalent fee for acceleration of the loan by exercise of a due-on-sale clause; and (3) waives its option to exercise a due-on-sale clause as to a specific transfer, if, before the transfer the association and the person to whom the property is to be sold or transferred (the existing borrower's successor in interest) agree in writing that
FS&Ls to include, at their option, a provision to declare the remaining loan principal due and payable if the property is transferred or sold by the borrower without the association's prior written consent. The regulations disallow exercise of the clause where the property is encumbered by a junior lien, or by a purchase money loan for household appliances, or where the property is transferred by devise or descent or to a surviving joint tenant by operation of law. Likewise, if the property owner grants a leasehold interest of three years or less which does not contain an option to purchase, the clause cannot be exercised. If the clause is used, the association may not charge the borrower a prepayment fee, as otherwise allowed when a borrower voluntarily prepays a loan.

The regulations also allow the FS&Ls to waive the acceleration option if the parties (FS&L and new purchaser) agree in writing that the transferee is a satisfactory credit risk and if the transferee agrees to pay interest on the loan at a rate the association requests. One section also provides that such agreement shall release the original borrower from the obligations of the mortgage so that the transferee has a "new" loan agreement with the lender.

the person's credit is satisfactory to the association and that interest on sums secured by the association's security interest will be payable at a rate the association shall request. Upon such agreement and resultant waiver the association shall release the existing borrower from all obligations under the loan instruments, and the association is deemed to have made a new loan to the existing borrower's successor in interest.

105. 12 C.F.R. § 545.8-3(f) (1980).
106. Id. § 545.8-3(g)(1)(i).
107. Id. § 545.8-3(g)(1)(ii).
108. Id. § 545.8-3(g)(1)(iii).
109. Id. § 545.8-3(g)(1)(iv).
110. Id. § 545.8-3(g)(2).
111. Id. § 545.8-5(b). This section allows for a prepayment charge on residential loans when expressly provided for in the contract and up to a maximum amount.
112. Id. § 545.8-3(g)(3). It is not clear, in the situation where the lender waives the option to exercise a due-on-sale clause and simply transfers the loan with a renegotiated rate, whether the FS&L could impose a prepayment fee on the original borrower since it was not, technically, exercising the due-on-sale clause. See supra text accompanying notes 110-11. This is unlikely under 12 C.F.R. § 556.9(b) (1981) which sets forth the FHLBB's disfavor of prepayment charges on all loans including those made before July 31, 1976.
113. 12 C.F.R. § 545.8-3(g)(3) (1981). This section provides an advantage to the seller in jurisdictions where a transfer or conveyance of the property "subject to" the mortgage does not affect the underlying obligation of the original borrower to the lender.

If a new purchaser defaults in payments to the lender and the lender exercises his right of action against the borrower, the borrower does have a right of action against the new purchaser that the property be exhausted first in payment of the debt. G. OSBORNE, supra note 1, at 251-52; see Syracuse Trust Co. v. First Trust & Dep. Co., 141 Misc. 603, 605, 252 N.Y.S. 2nd.
In another regulation, added July 3, 1979, the FHLBB enumerated additional circumstances where the federal associations will find it appropriate to waive acceleration of the loan. These situations include “transfer of title to members of the borrower's immediate family, including a former spouse in connection with a divorce, who occupy or will occupy the property.” The regulations also advise associations to consider waiving the right to require an interest increase under a due-on-sale clause “in cases of extreme hardship to the existing borrower.”

It has been argued that these federal regulations preempt state law in jurisdictions, like California, where the automatic enforceability of the clause is not permitted. As a result, there is presently a conflict in the California appellate courts as to the preemptive effect of the FHLBB's regulations on the Wellenkamp rule.

A. The California Position

In June 1981, in *Panko v. Pan American Federal Savings & Loan Association*, the California Court of Appeals for the First District upheld state law in a suit against a FS&L by transferees of commercial property. The court held that the California rule which requires a lender's showing of impaired security before enforcing a due-on-sale clause “[neither] infringes upon [n]or is otherwise incompatible with the regulation or operation of the internal affairs of federal savings and loan associations.” While the court recognized the FHLBB's unqualified intention to preempt state laws by its regulations and policy, it noted the lack of reference to the subject of

850, 854 (Sup. Ct. 1931).

This clause has been described as an attempt to side step the Board's policy not to increase the interest rate during the course of the loan term. See 12 C.F.R. § 541.14(a) (1977). Since 1980, however the Board has allowed alternative mortgage instruments which allow variation in the interest amount during the loan term. See the new regulations on alternative mortgage instruments (AMLs) effective May 1981, 46 Fed. Reg. 24,148 (1981) (to be codified in 12 C.F.R. Part 545 (1981)).

114. 12 C.F.R. § 556.9(c) (1981).

115. Id.

116. Id.

117. See supra notes 67-68 and accompanying text; see infra note 287.

118. See supra notes 120-44 and accompanying text; see infra note 287.


121. Id. at 923, 174 Cal. Rptr. at 245.

122. Id. at 922, 174 Cal. Rptr. at 244.
due-on-sale clauses in the Home Owner's Loan Act (HOLA) and concluded that there was no evidence of "a clear congressional mandate that federal law shall control the subject matter herein."\(^{123}\) The court reasoned that California law merely imposed a more stringent requirement of threatened lender security before enforcing due-on-sale clauses. Quoting from a Minnesota case, the *Panko* court noted that federal regulations authorize but do not compel use of the due-on-sale clause.\(^{124}\) Since California only imposes a more stringent requirement on the use of the clause, the result was not deemed an "inevitable collision" between the two regulations.\(^{125}\) Instead, "the federal regulation leaves the rights and remedies of the parties intact under the terms of the loan contract."\(^{126}\) Thus, "enforcement of the due-on-sale clause rests upon conventional contract and property principles under state law."\(^{127}\) This decision, denied an appeal by the California Supreme Court, has been appealed to the United States Supreme Court.\(^{128}\)

In *de La Cuesta v. Fidelity Federal Savings & Loan Association*,\(^{129}\) the fourth appellate district in California, following the

---

123. *Id.*

124. *Id.* at 923, 174 Cal. Rptr. at 245 (citing *Holiday Acres* No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981)). The *Holiday Acres* court upheld the due-on-sale clause as not per se unreasonable where the loan contract concerned investment residential property and no inequities in bargaining were proved. 308 N.W.2d at 484. It held, however, that federal law regarding due-on-sale clauses did not preempt Minnesota law on the subject. *Id.* at 480.

125. 119 Cal. App. 3d at 922, 174 Cal. Rptr. at 245 (citing *Florida Avocado Growers v. Paul*, 373 U.S. 132, 142 (1963) for general proposition that federal law preempts state law when there is collision or impossibility of dual compliance with two schemes of regulation).

126. *Id.* at 924, 174 Cal. Rptr. at 245. The loan agreement was a standardized form used by FS&Ls by agreement with FHLMC, a secondary purchaser of mortgages. The court noted the clause in the agreement which states: "This Deed of Trust shall be governed by the law of the Jurisdiction in which the property is located." *Id.* at 925, 174 Cal. Rptr. at 246. See the discussion regarding the FS&Ls' use of this clause, *supra* notes 10, 103-16.

127. *Id.* at 924, 174 Cal Rptr. at 245 (citing *Holiday Acres*, 308 N.W.2d at 477 (Minn. 1981)).


129. 121 Cal. App. 3d 328, 175 Cal. Rptr. 467 (1981), review denied, L.A.D.J., Aug. 25, 1981, at 2, col. 3 (Cal. Aug. 24, 1981), *prob. juris. noted*, 50 U.S.L.W. 3591 (U.S. Jan. 26, 1982) (No. 81-750). This case involved three consolidated cases (one involving commercial property). The appellate court reversed the lower court's summary judgment in favor of the lender, ruling that the FS&L could not exercise the due-on-sale clause without showing risk to the security and the fact that one deed involved commercial property did not change the result. 121 Cal. App. at 329, 175 Cal. Rptr. at 468. As to the treatment of commercial property contracts with due-on-sale clauses, see *supra* notes 70-74 and accompanying text; see infra note 287.
Panko court's lead and paraphrasing its opinion, also held that the federal regulations do not override the California law. This decision, also denied a hearing by the state's high court, has been granted review by the United States Supreme Court.¹³⁰

The California trend against preemption, however, did not influence the state's second district appellate court in People v. Glendale Federal Savings & Loan Association.¹³¹ The case was decided on appeal after remand by a federal district court.¹³² A unanimous panel¹³³ rejected the trial court's notion that it was bound by the federal district court's ruling in another case, Glendale Federal v. Fox,¹³⁴ that had upheld federal preemption only as to FS&L loan agreements made after June 1976. Instead, the issue was more broadly defined as whether or not the regulatory power of the FHLBB is sufficient to preempt state regulation. The court determined that there was no reason to differentiate between loans made before June 1976 and those made after the date of the latest federal regulation.¹³⁵ After examining the two tests generally applicable to a preemption analysis, namely (1) whether Congress manifested an express intent to preempt the field or, (2) whether an irreconcilable conflict exists between the two regulations,¹³⁶ the court concluded that "application of either test to the issue here leads inexorably to

¹³⁰ 50 U.S.L.W. 3591 (U.S. Jan. 26, 1982) (No. 81-750). The Court's decision could affect more than 600 similar cases in California courts, including 40 against Fidelity Federal.


¹³² 475 F. Supp. 728 (C.D. Cal. 1979). The federal district court held that the FS&L's defense of federal preemption did not give rise to federal question jurisdiction, nor did the intervention of the FHLBB create jurisdiction. Therefore, no decision on the merits was reached and the case was remanded to the trial court. See infra text accompanying notes 145-57.

¹³³ 122 Cal. App. 3d at 870, 176 Cal. Rptr. at 358.


¹³⁵ 122 Cal. App. 3d at 865, 176 Cal. Rptr. at 355. The FHLBB has construed its policy and regulations as always granting authority to its associations to use due-on-sale clauses both before and after the specific provisions were added to its regulations. See infra notes 158-64 and accompanying text.

¹³⁶ 122 Cal. App. 3d at 866-67, 176 Cal. Rptr. at 356.
the conclusion that state law has been effectively preempted." The court reasoned that the Wellenkamp rule is in "direct and unavoidable conflict with the Board's regulation, in that California would deny enforcement of a contractual clause specifically authorized by the Board."

Having recognized the direct conflict, the court restated the issue as simply whether the federal due-on-sale regulation was a valid exercise of the plenary power bestowed on the FHLBB by Congress. It concluded that the very justification for establishing regulatory agencies was to relieve Congress from having to legislate such "loan details." In discussing the Wellenkamp decision, the court noted that even Wellenkamp did not declare the due-on-sale clause invalid per se, nor did it attempt to bar its enforcement completely. Rather, Wellenkamp only intended to limit enforcement of the clause under market conditions characterized by high interest rates and tight money which inhibit transfer of property and thereby increase the clause's restraining effect on alienation. Declining to extend the Wellenkamp rule "unnecessarily or give it a status that ousts federal regulation," the appellate court reversed and remanded the action to the trial court for judgment in favor of the defendant FS&L.

The California appellate courts, therefore, are in conflict as to the preemptive nature of the FHLBBs regulations on the FS&Ls

137. Id.
138. Id. at 867, 176 Cal. Rptr. at 356.
139. Id.
140. Id. at 868, 176 Cal. Rptr. at 356. But see cases cited supra notes 120-29. The California appellate court notes with disapproval the trial court's interpretation of the lack of express provision as to such loan details in the FHLBB's enabling statute, 12 U.S.C. §§ 1461-70 (1976), as evidence of a lack of congressional mandate that federal law was intended to control such details:

It would seem that if Congress had intended federal savings and loan practices to be subject to state regulation as to 'loan details', it would have been a simple matter for it to say just that. Congress' failure to specifically authorize by legislation all of the various permissible clauses to be used in lending instruments cannot be read logically to indicate such an intent.

122 Cal. App. 3d at 868, 176 Cal. Rptr. at 357.
141. Id. at 869, 176 Cal. Rptr. at 357.
142. Id.; see supra text accompanying notes 46-47.
144. 122 Cal. App. 3d at 870, 176 Cal. Rptr. at 358.
located in that state. Resolution of this controversy must await the United States Supreme Court’s decision on the cases pending its review.

B. The Jurisdictional Hurdle

The FS&Ls are understandably reluctant to submit to judicial review in jurisdictions that have previously denied automatic enforcement of due-on-sale clauses. For this reason, they have exercised their removal options in order to plead their case to a more sympathetic federal ear. This action has been frustrated, however, by jurisdictional problems that have forced the federal courts to remand most of the cases to the state court arena on grounds that, without diversity of parties, there is no federal jurisdiction. Since the cases removed to federal courts often involve a plaintiff who is a borrower or transferee seeking either enforcement of a state law or a remedy under state property law, the federal courts have held that the FS&Ls’ defense of federal preemption is not a federal question raised on the face of the complaint.

Nevertheless, those federal district courts which have determined the merits of the preemption controversy, despite frequent dismissal or reversal on jurisdictional grounds, have followed the reasoning in *Glendale v. Fox* in favor of preemption of state law. In


149. 459 F. Supp. 903 (C.D. Cal. 1978); *see supra* text accompanying note 147; *see also* Price v. Florida Fed. Sav. & Loan Ass’n, 524 F. Supp. 175 (M.D. Fla. 1981) in which Justice
cases involving loans made or transferred after the FHLBB's June 1976 regulations,\textsuperscript{150} the preemption decisions have generally relied on the apparent conflict between federal and state law.\textsuperscript{151} In cases dealing with pre-June 1976 mortgages, however, the courts have also upheld federal preemption ostensibly because Congress has occupied the field via the pervasive nature of federal legislation and regulations.\textsuperscript{152}

In May 1981, a federal circuit court, retaining jurisdiction due to the parties' diversity, commented on the preemption issue in Williams v. First Federal Savings & Loan Association of Arlington.\textsuperscript{153} The court decided that the due-on-sale clause was enforceable under Virginia state law because it did not constitute a restraint on alienation.\textsuperscript{154} Hence, the decision allowed the court to avoid the preemption issue.\textsuperscript{155} While the Williams court noted some potential problems with the preemption argument because one of the defendant lenders was state chartered and one of the loan agreements was executed before June 1976,\textsuperscript{156} it recognized that there was authority, nevertheless, for the federal preemption defense.\textsuperscript{157}

C. Federal Regulation

The FHLBB, from the outset, has been adamant in its position that federal regulations govern enforcement of due-on-sale clauses in loans made by federally chartered lending institutions.\textsuperscript{158} The spe-

\textsuperscript{150} The text of those regulations is set out supra at note 104.
\textsuperscript{151} See cases cited supra note 148.
\textsuperscript{152} See, e.g., First Fed. Sav. & Loan Ass'n of Gadsen Cty. v. Peterson, 516 F. Supp. 732, 738 (N.D. Fla. 1981) ("Federal regulation on the subject of due-on-sale clauses is pervasive. It is direct; it is explicit; and it leaves no room for state law on the subject be it harsher or more lenient.").
\textsuperscript{153} 651 F.2d 910, 922-23 (4th Cir. 1981). The court had jurisdiction over three consolidated cases: one under diversity of parties, and the others involving a federal question as to whether the type of transfer of property (a sale of beneficial ownership) constituted a transfer as contemplated by the federal regulations.
\textsuperscript{154} Id. at 923-24.
\textsuperscript{155} Id. at 921-23.
\textsuperscript{156} Id. at 922.
\textsuperscript{157} Id.
specific provisions added in 1976 and 1979 to its regulations\textsuperscript{159} and policy\textsuperscript{160} reinforce the Board's position that FS&Ls have the right to enforce due-on-sale clauses as a legitimate interest-raising device when necessary. This policy applies to pre- as well as post-1976 loans as evidenced by the language of the 1976 regulations. The regulations state that federal associations \textit{continue} to have the power to include due-on-sale clauses in mortgage contracts.\textsuperscript{161} The Board's position is that this policy was codified in 1976 but that the codification only represents confirmation of a pre-existing policy to allow inclusion of due-on-sale clauses.

The Board has recently reiterated its policy in a final rule adopted July 23, 1981,\textsuperscript{162} which reasserted the preemptive nature of the regulations "in order to allay the uncertainty expressed by a few state courts."\textsuperscript{163} The rule also codified its rationale for authorizing rather than compelling use of the due-on-sale clause by federal

\begin{itemize}
\item \textsuperscript{159} 12 C.F.R. § 545.6-11(d)-(g) (1977) (current version at 12 C.F.R. § 545.8-3(f)-(g) (1981)).
\item \textsuperscript{160} 12 C.F.R. § 556.9 (1981).
\item \textsuperscript{161} 12 C.F.R. § 545.6-11(f) (1977) recodified at § 545.8-3(f) (1981).
\end{itemize}

Part 556-Statements of Policy

Amend § 556.9 by adding a new paragraph (f) thereto, to read as follows:

§ 556.9 Imposition of late charges and due-on-sale clauses.

\textit{(f) Due-on-sale policy and Federal preemption.} [1] Federal associations are obliged to take reasonable precautions to protect themselves against the economic risks associated with mortgage lending, including the risk that the cost of lendable funds will exceed the yield from existing mortgage loans, and that sharply rising interest rates will reduce substantially the value of existing mortgage assets. In this connection, the Board has determined that the due-on-sale clause normally is a valuable and often an indispensable source of protection for the financial soundness of Federal associations and for their continued ability to fund new home loan commitments. Consequently, the Board for many years has authorized due-on-sale clauses for use by Federal associations. However, because the Board desires to afford associations the flexibility to accommodate special situations and circumstances, § 545.8-3(f) of this Subchapter by its terms merely authorizes rather than compels the inclusion and exercise of due-on-sale clauses in mortgage loans.

[2] Paragraph (f) of § 545.8-3 confirms the continuing authority of Federal associations to include due-on-sale clauses in their mortgage loan contracts and to exercise such clauses, subject only to the express limitations contained in § 545.8-3(g). Due-on-sale practices of Federal associations shall be governed exclusively by the Board's regulations, in preemption of and without regard to any limitations imposed by state law on either their inclusion or exercise including, but not confined to, state law prohibitions against restraints on alienation, prohibitions against penalties and forfeitures, equitable restrictions and state law dealing with equitable transfers.

\begin{itemize}
\end{itemize}
On September 23, 1981, the Comptroller of the Currency proposed a rule that would authorize inclusion of due-on-sale clauses in real estate loans made by national banks and make such clauses fully enforceable notwithstanding contrary state law. The rule would also re-validate due-on-sale clauses in outstanding loans that were impaired or questioned by court decisions or state statutes.

In the proposed rule, the Comptroller concedes the battle as to the use of the clause in mortgage loan contracts which were made, assumed or transferred prior to the effective date of the regulations and during a period when a state had a statute or judicial decision in effect which rendered the clause invalid or unenforceable (the "window period"). This regulation, by preemption law to the contrary, would resurrect dormant due-on-sale clauses in mortgages which have been previously transferred and which could otherwise be assumed in the future. Likewise, preemption would allow national banks to enforce all new loans with due-on-sale clauses and older loans which contain the clause but have never been transferred.

The Comptroller has also authorized the use of the clauses in adjustable rate mortgage loans made by national banks. In answer to certain courts' concern with disclosure and the ambiguous language of the due-on-sale provisions, the issues of reasonableness and consent are addressed by specific disclosure guidelines in the regulations which require, inter alia, disclosure to the prospective borrower regarding any prepayment fees and acceleration upon transfer. Consumer disclosure is further required by the loan contract itself which must contain specific information about the as-

164. Id.
167. Id.
169. See id.
170. See id. The misconception that the proposed rule would mandate the use of the due-on-sale clause in all national bank loans and that it would nullify the assumability of some current mortgages, has fueled the negative comment on this issue and prompted the Comptroller to issue a clarification letter. [July-Dec.] WASH. FIN. REP. (BNA) No. 48, at B-2 (Dec. 7, 1981).
174. Id. at 18,944-45 (to be codified at 12 C.F.R. § 29.8(a)(7) (1981)).
sumability of the loan if the bank wants to secure the option to exercise a due-on-sale clause at any time.175

The FHLBB's new regulations on its adjustable mortgage loans (AMLs)176 do not specifically mention use of due-on-sale clauses, but the regulations do include a specific preemption provision177 regarding any state law purporting to address or restrict the FS&Ls' ability to make or participate in AML instruments. These regulations replace existing provisions regarding lenders' authority to issue renegotiable rate mortgages (RRMs)178 and variable rate mortgages (VRMs).179 The Board also deleted the requirement that FS&Ls offer a choice of a fixed rate mortgage to applicants who are eligible for an alternative mortgage loan.180

The National Credit Union Administration (NCUA), on July 22, 1981, also promulgated a final rule181 designed to clarify its existing policy to require182 due-on-sale clauses in its real estate loan agreements. The exercise of the clause at the time of transfer is optional with the lender183 however, subject to similar specific exceptions as outlined in the FHLBB's due-on-sale provisions.184

D. Proposed Federal Legislation

Senator Garn, of the Senate Banking Committee, has introduced legislation,185 drafted by the chairman of the FHLBB, which would greatly expand all FS&L practices to permit them to take commercial deposits and make commercial loans.186 The bill would allow FS&Ls, national banks and federal credit unions to use due-on-sale clauses in their mortgage loans.187

175. Id. at 18,944 (to be codified at 12 C.F.R. § 29.7 (1981)).
177. Id. at 24,152 (1981) (to be codified at 12 C.F.R. § 545.6-4(a)(2)).
179. Id. (replacing 12 C.F.R. § 545.6-4(c) (1980)).
180. Id. (amending 12 C.F.R. § 545.6-4(a) (1980)).
182. The FHLBB's final rule and the Comptroller's proposed rule allow but do not require the use of a due-on-sale clause.
184. See supra notes 120-27 and accompanying text.
A second bill,188 also introduced by Senator Garn, is more expansive as to the powers of savings institutions, and would allow the due-on-sale clause to be used by all federally-chartered institutions, and state-chartered institutions whose deposits are covered under a federal deposit insurance program.189

Either bill would preempt contrary state law. The second bill seeks greater uniformity, however, as to state and federal lenders’ use of the due-on-sale clause.190 In addition, the purpose of introducing federal legislation to preempt state law was to clarify the authority of the three regulatory agencies’ rules regarding due-on-sale, and not to imply any present lack of agency authority to preempt state law.191

IV. THE STATE OF AFFAIRS IN NEW YORK

The due-on-sale clause first received judicial endorsement in New York in 1970 in *Stith v. Hudson City Savings Institution*.192 In *Stith*, the court upheld the due-on-sale clause and legitimized the lender’s protection of the mortgage portfolio as a reasonable justification for the acceleration.193 The specific provision in the contract194 required the saving institution’s consent to allow assumption of the mortgage.195 When the borrowers conveyed the property to the Stiths almost seven years later, the lender agreed to the transfer only

---

191. See Giblin Interview, supra note 190.
192. 63 Misc. 2d 863, 313 N.Y.S.2d 804 (Sup. Ct. 1970). The defendant was a state-chartered savings institution.
193. Id. at 868, 313 N.Y.S.2d at 808.
194. The clause read:
“In the event the obligors sell or convey the property which has been given as security for this bond, this obligation cannot be assumed without the consent in writing of the mortgagee, and if said consent is withheld all sums due hereunder, both principal and interest, will become immediately due and payable.”
Id. at 864, 313 N.Y.S.2d at 806 (quoting bond clause).
195. Although there was no reasonableness standard in the clause as to the granting of consent, the original borrower, Kennedy, claimed that he had received assurance from the independent mortgage servicing representative that “a lending institution would not withhold its consent unreasonably if a financially qualified person . . . agreed to assume the mortgage as part of the purchase price.” Id. at 864, 313 N.Y.S.2d at 806.
on the condition that the interest rate increase by one and one half percent. The purchasers then brought the action seeking a declaratory judgment that the lender’s action was illegal, basing their argument on a New York law which prohibited an interest increase beyond the maximum rate authorized at the time the loan was made. The court dismissed this argument, noting that the law only prevents a lender from arbitrarily terminating loan agreements in order to make “new” loans at higher rates, if such are in effect. The court also observed that the law did not apply if the “accelerated maturity of the loan results from the [borrower’s] act or default,” as was the situation given the borrowers’ violation of the consent clause in the contract. In its holding the court cited language from Cherry v. Home Savings & Loan Association, which unquestioningly approved the lender’s option to employ due-on-sale clauses as a means of securing a “‘higher return for the use of its money’” than obtained from the original borrowers, and held that such action “‘demonstrated no lack of good faith or fair dealing.’” The court also noted that the lender had “‘no obligation to act only in a manner which others might term ‘reasonable.’”

Seven years later, in Mutual Real Estate Investment Trust v. Buffalo Savings Bank, a New York court again upheld a due-on-sale clause, this time in a commercial context. The borrower-plaintiff was a real estate investment trust seeking to convey income-producing property to a purchaser of sound financial means. The borrower sought to enjoin acceleration of the mortgage by the defendant savings bank and a declaration that the bank’s actions were unreasonable in light of the superior financial status of the purchaser.

196. Id. at 865, 313 N.Y.S.2d at 807. The original borrowers had purchased the property at 6% interest in October 1962. The bank sought an increase to 7½% in April 1969.
197. Id. at 867, 313 N.Y.S.2d at 808-09 (construing N.Y. Gen. Oblig. Law § 5-501(4)).
198. Id. at 867, 313 N.Y.S.2d at 809 (construing 3 N.Y.C.R.R. § 4.6).
199. Id. at 868, 313 N.Y.S.2d at 809-10 (citing Cherry v. Home Sav. & Loan Ass’n, 276 Cal. App. 2d 574, 579, 81 Cal. Rptr. 135, 138-39 (1969)).
200. Id.
201. Id.
202. Id.
204. The defendant was a New York chartered savings bank. Id. at 676, 395 N.Y.S.2d at 584.
205. The parties disagreed as to whether the financial soundness of the purchaser had been determined to the lender’s full satisfaction. Both parties also contended that Pennsylvania law should apply since the property was located in that state. Finding no Pennsylvania law on point, the court presumed that the law there was the same as New York’s law. It also noted...
Citing Stith, the court approved the Stith rationale for allowing the lender to reappraise the desirability of the loan from the standpoint of the value of the security covered and "the interest rate obtainable in the current money market."\(^{206}\) The court did note that the issue of mortgage foreclosure fell within the equity jurisdiction of the court and indicated that there could be circumstances which would render the lender's enforcement of a due-on-sale clause unconscionable.\(^{207}\) The court held, however, that because the borrower had not shown such unconscionable circumstances the enforcement of the clause did not constitute an inequity.\(^{208}\)

Such an inequitable situation did arise in Nichols v. Evans,\(^{209}\) where the court refused to grant summary judgment in favor of the plaintiff-lenders who were not a lending institution but, apparently, private individuals who were either purchase money mortgagees or private investors. The lender had attempted to foreclose a mortgage via a due-on-sale clause when the property's co-owners merely transferred the title to a corporate entity of which they were principals.\(^{210}\) While citing Stith as the only New York authority on the subject,\(^{211}\) the court focused on the specific conduct of the defendants and recognized the equitable considerations relied on to avoid enforcement of the clause in other jurisdictions "where the prevailing practice has not been to compel forfeiture solely because a conveyance has taken place contrary to a due-on-sale provision."\(^{212}\) The court's reliance on

---

\(^{206}\) Id. at 678, 395 N.Y.S.2d at 585-86 (citing Stith v. Hudson City Sav. & Loan Inst., 63 Misc. 2d 863, 866, 313 N.Y.S.2d 804, 808 (Sup. Ct. N.Y. Cty. 1970)).

\(^{207}\) 90 Misc. 2d at 678-79, 395 N.Y.S.2d at 586.

\(^{208}\) Id.


\(^{210}\) The borrowers had made late payments on two earlier occasions which they attributed to their distraction over their daughter's death. They had also offered to cure their default by a re-conveyance of the title back to themselves as individual owners. The conveyance to the corporation had been made in March 1976, but the lenders did not seek enforcement of the acceleration clause until after June 1977. Id. at 939-41, 401 N.Y.S.2d at 427-28.

\(^{211}\) Id. at 940, 401 N.Y.S.2d at 427. The court later mentions dicta from the Buffalo Savings Bank opinion which stated that "under certain circumstances, it may be inequitable to enforce a due-on-sale provision." 92 Misc. 2d at 941, 401 N.Y.S.2d at 428 (citing Mut. Real Estate Inv. Trust v. Buffalo Sav. Bank, 90 Misc. 2d 675, 678, 395 N.Y.S.2d 583, 586 (Sup. Ct. N.Y. Cty. 1977)).

\(^{212}\) 92 Misc. 2d at 940, 401 N.Y.S.2d at 428 (citing United States v. Angel, 362 F. Supp. 445 (E.D. Pa. 1973) which did not involve a due-on-sale clause but an attempted foreclosure for minor violations of health and safety codes, and citing Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974) which was heavily relied on by the Wellenkamp court).
other jurisdictions' authority to avoid an injustice in this case is understandable. The citation to cases which do not allow acceleration unless the lender can show a threat to the security, however, could be read as a step backwards from the Stith and Buffalo reasoning which recognized readjustment of the interest rate as another justification for due-on-sale acceleration.

The three lower court decisions in Stith, Buffalo and Nichols were followed by a New York appellate decision in Silver v. Rochester Savings Bank. The court, reversing the lower court, held that the defendant bank could not condition its approval of the property transfer on the new purchaser's acceptance of an increase in the interest rate. The facts of the case are pertinent, however, in clarifying the court's rationale. The appellee savings bank was both the mortgagee and the lessee of the property owner. Also, the bank had reserved first refusal rights to purchase the property but decided not to meet the new purchaser's price, which was contingent on the bank's allowing the assumption of the same interest rate. Perhaps most important was the fact that the bank had agreed in the due-on-sale provision that it would not unreasonably withhold its consent to any term in the mortgage which required its approval.

Because the lender established its own standard of reasonableness in the loan agreement and acknowledged that the proposed

213. E.g., Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 252 Ark. 849, 481 S.W.2d 725 (1972) (savings and loan not entitled to equitable relief absent a showing that lender's security is threatened); see also authorities cited supra note 68.
214. 63 Misc. 2d at 868, 313 N.Y.S.2d at 809-10.
215. 90 Misc. 2d at 678-80, 395 N.Y.S.2d at 586.
216. 73 A.D.2d 81, 424 N.Y.S.2d 945 (4th Dep't 1980).
217. The lower court held that the defendant savings bank had the right to withhold consent to the transfer. Id. at 86, 424 N.Y.S.2d at 947.
218. Id. at 85, 424 N.Y.S.2d at 948.
219. Id. at 82-83, 424 N.Y.S.2d at 946.
220. The appellee bank was a state-chartered savings bank. Id. at 82, 424 N.Y.S.2d at 946.
221. 73 A.D.2d at 83, 424 N.Y.S.2d at 946.
222. Id. at 82-83, 424 N.Y.S.2d at 946. The original interest rate, established in 1973, was 8.5%. The bank sought an increase, upon transfer in 1979, to 10.5%. Id.
223. The mortgage terms provided:
"Should the Mortgagor transfer title to mortgaged premises . . . without first obtaining the written consent of Mortgagee . . . Mortgagee shall have the option to declare the whole of the unpaid principal sum . . . due and payable. . . . [W]here any of the terms . . . of this mortgage require the approval . . . or consent of Mortgagee . . . [then] shall not be unreasonably withheld. . . ."
Id. at 83, 424 N.Y.S.2d at 946 (emphasis added).
224. The clause in the mortgage in which the bank agreed not to unreasonably withhold
purchaser was financially sound, the court ruled that the intention in placing such a due-on-sale provision in the agreement was to protect its security interest, and not to raise the interest rate at transfer. It therefore granted summary judgment in favor of the borrower.

While the court confined its holding to the contractual terms peculiar to this case, its reasoning in regard to the equity investment of the landowner and the reduced investment return of the purchaser if a higher rate was allowed, could foreshadow a shift to the consumer-oriented reasoning of Wellenkamp and its progeny. The court did comment, in a footnote, that if the bank had expressly provided for the right to raise the rate of interest, "a different question would be presented" due to the notice thereby given to the borrower. The court further noted that "there is authority that the [due-on-sale] provision, exercised in good faith, would be valid."

Although this case could be viewed as confined to its own special facts, the court's discussion of the equitable issues in due-on-sale controversies, albeit in dicta, could also signal a "predisposition against the use of a due-on[-sale] clause for interest rate adjustment purposes." If so, the stability of the due-on-sale clause in New York may wash away in the sweeping tide of the Wellenkamp reasoning.

The fate of a due-on-sale clause in a mortgage loan made by a federally-chartered savings and loan association, however, was recently determined by a lower New York court. In First Federal Savings & Loan Association of Rochester v. Jenkins, the court, granting summary judgment, upheld the FS&L's enforcement of a due-on-sale provision in a 1978 mortgage loan agreement. Recognizing the preemptive nature of the federal regulations on this issue, the consent was the fatal flaw. The court noted that where due-on-sale clauses had been upheld in other jurisdictions, there had never been such a clause in the agreement. Conversely, courts that had restricted the lender's use of the due-on-sale clause had done so by implying just such a duty to act reasonably. Id. at 86, 424 N.Y.S.2d at 948.

...
court ruled that such regulations applied to the facts therein.\textsuperscript{234} While the court dismissed the defendants’ claim that New York law should apply, it noted that the clause was generally enforceable under New York law and that the New York legislature had “obliquely recognized” the validity of the clause.\textsuperscript{235}

V. ECONOMIC ISSUES AND DUE-ON-SALE

Although the economic and legal issues are complex, there are several observations that can be made about the economic impact of the due-on-sale clause on today’s housing market.\textsuperscript{236} Buyers and sellers benefit from assumability of interest rates and limiting the due-on-sale clause’s enforcement, but this benefit is at the expense of the lenders and the general home finance market.\textsuperscript{237} When the loan to value ratio\textsuperscript{238} is sufficient to cover the risk of transfer to an even less financially secure buyer than the original borrower, it is less reasonable to enforce a due-on-sale clause using only a security risk rationale.\textsuperscript{239} Likewise, even under most mortgage transfer agreements, the original purchaser remains liable on the note obligation in the event of default by the second purchaser.\textsuperscript{240} In addition, the increased use of insurance for mortgages offers greater protection and lower risk to the lender.\textsuperscript{241}

The \textit{Wellenkamp}\textsuperscript{242} reasoning suggests that lenders should accurately forecast future interest rates or bear the expense of their inaccuracy. This view, however, ignores the market practice on which lenders rely with regard to the expected turnover rate of loans

\begin{itemize}
\item \textsuperscript{234} Id. at 722-23, 441 N.Y.S.2d at 378 (citations omitted).
\item \textsuperscript{235} Id. at 724, 441 N.Y.S.2d at 379 (citations omitted).
\item \textsuperscript{236} See generally, Finch, supra note 55.
\item \textsuperscript{237} OFFICE OF HOUSING & COMMUNITY DEVELOPMENT, U.S. DEP’T OF HUD, OFFICE OF POLICY DEVELOPMENT & RESEARCH, HOUSING AND COMMUNITY DEVELOPMENT CONFERENCE REPORT (1980) at 5-6 [hereinafter cited as HUD STUDY].
\item \textsuperscript{238} The loan to value ratio is the ratio of the balance of the loan principal to the value of the property. Since the lender always has a right of foreclosure against the property in the event the mortgagors default, a low loan to value ratio helps assure the lender of a sale price high enough to cover the loan balance.
\item \textsuperscript{239} Comment, supra note 10, at 482. The author suggested that a court consider a safe security ratio for the lender to lie somewhere between 60% and below (i.e. the outstanding debt would not be greater than 60% of the market value of the house), given the fact that, at a judicial foreclosure sale, the property is often sold for less than the full market value. Id.
\item \textsuperscript{240} See G. OSBORNE, supra note 1, at 249, 252.
\item \textsuperscript{241} Comment, supra note 10, at 484.
\item \textsuperscript{242} See \textit{Wellenkamp v. Bank of America}, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).
\end{itemize}
Judicial willingness to set aside contractual provisions espouses an attitude that economic market solutions are inadequate. Such action has prompted the observation that there is no indication of judicial balancing of the interests involved, nor any "appreciation of the forces at work in the markets. Unfortunately, however, the underlying problems which prompted the invocation of the clause in the first instance will not stay indefinitely under the rug where the court swept them."

Also, the judicial implication that the use of the due-on-sale clause by lenders is a form of economic duress is misplaced. The criticism that the clause is an unreasonable restraint on alienation likewise fails to distinguish reasonable restraints that can be removed by private agreement from those that cannot. The due-on-sale clause only "shifts to the [lender] the advantage from the increase in interest rates which would otherwise belong to the seller."

In 1979 FS&Ls had almost half of their mortgage portfolios outstanding at an interest rate of less than nine percent while receiving interest of twelve percent or more on only five percent of their mortgages. This situation requires state and federal savings and


[A]lthough mortgage loans are generally written for terms of twenty-five to thirty-five years, the average homeowner does not remain in one residence until his mortgage is repaid. In fact, figures submitted by [saving banks' associations] tend to establish that mortgages originating in the 1960's remained outstanding on the average from 6.5 to 9.8 years. *Id.*


246. See Epstein, *supra* note 244, at 313. This commentator has drawn a distinction between the defense of duress where the circumstances involve actual "duress of goods" or duress of consent from "economic duress" where "if A does not like B's offer, he can reject it." The true defense of duress does not "turn upon the reasonableness of the terms of the agreement; nor . . . upon the market position of the parties to it immediately before it was formed." *Id.* at 296. Hence, "*[e]conomic duress' is not a simple generalization of the common law notions of duress, it is their repudiation. The integrity of the law of contract can be preserved only if that notion is flatly and fully rejected." *Id.* at 297.


248. Epstein, *supra* note 244, at 312.

249. *Id.*

loans to reassess their market strategies to avoid the “flawed strategy” of borrowing short and lending long. 251 Richard Pratt, chairman of the FHLBB, has advised that “the [FS&L] industry is in danger of losing $5 billion dollars this year and ‘can no longer afford to subsidize homebuyers.’” 252

Banking deregulation 253 has increased the vulnerability of savings and loan associations by removing interest deposit ceilings and other insulating regulations. 254 “[T]hrifts have been forced into the competitive short term market for deposits [while] encumbered by portfolios with long term low interest rate loans.” 255 This especially affects state chartered S&Ls in states where due-on-sale enforcement has been limited 256 because, although challenged in many states, FS&Ls are better protected by the FHLBB’s regulations which do allow use of the clause. One other consideration is the restriction placed on secondary market agencies 257 such as the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) by the lack of state uniformity in regard to the enforceability of the due-on-sale clauses. 258

FED. HOME LOAN BANK BD. J., July 1981, at 25, 27 (chart 2).
253. See [July-Dec.] WASH. FIN. REP. (BNA) No. 31, at AA-1 (Aug. 3, 1981) (report on legislation allowing banks, S&Ls, and credit unions to issue “All Savers” certificates which earn interest at rate equal to 70% of one-year Treasury bill rate); [July-Dec.] WASH. FIN. REP. (BNA) No. 49, at A-22 (Dec. 14, 1981) (deposit rate regulations could leave S&Ls stuck with portfolios of low yielding mortgages while being forced to pay higher rates to retain deposits).
254. HUD STUDY, supra note 237, at 8.
255. Id.
256. E.g., authorities cited supra notes 67-70 and statutes cited supra notes 79-86, 89-92.
257. The agencies in the secondary mortgage markets buy mortgages from savings and loans to pool for resale to private investors, generating mortgage money for savings and loans to finance more residential loans. G. OSBORNE, supra note 1, at 314.
258. HUD STUDY, supra note 237, at 6. Since the shorter the mortgage period the greater the value of the mortgage for sale in the secondary market, the policy of FNMA is to require acceleration of the principal at transfer of the property via due-on-sale clauses. FNMA will only purchase mortgages that have a 7-year call provision in states that limit due-on-sale enforcement. As of January 1981, FNMA required this provision in 17 states including New York and California. Id. at 29.

A call-in provision in a mortgage can have adverse effects on the original borrower when the lender, at the end of the call-in period, requires repayment of the principal and refinancing. See N.Y. Times, Oct. 1, 1981, at B3, col. 3. A New York savings bank called in fifty mortgage loans, written in 1976 at 8.5%, offering to refinance at 15% for one year. Although the borrow-
One study has concluded that due-on-sale mortgage clauses should neither be prohibited nor required. Instead, borrowers and lenders should bargain for mutually acceptable terms which may or may not include the clause. While it has been suggested that the whole issue of due-on-sale may fade as alternative mortgage instruments become more common, dismissal of the issue would be premature. Because the great majority of currently outstanding loans are the fixed-rate type, with an average turnover rate of seven to ten years, the due-on-sale clause remains a potential thorn in the side of many lenders and borrowers.

The interest rate established for a fixed-rate mortgage reflects the cost of the lender’s assumption of the risk that interest rates will rise during the life of the loan. This may require an increased rate premium which, not unlike the premiums paid for life or accident insurance, is based on the lender’s assessment of the risk. When the indicators and the perception of the risk are low, the fixed-rate mortgage is a viable lending arrangement for both lender and borrower. When the risk is high, the cost may be too high for the average home borrower. In this situation, the variable rate arrangements are seen as the only viable alternative. The abandonment of fixed-rate loans, however, in favor of the more flexible mortgage arrangements, should not be regarded as the only solution to the continued survival of the housing finance industry. The due-on-sale clause helps to equalize the cost of mortgages so that future borrowers will not face higher interest rates—or forfeit the opportunity to make a fixed-rate loan—in order to subsidize holders of older,

259. HUD STUDY, supra note 237, at 2.
260. Id.
261. See G. Osborne, supra note 1, at 307.
262. Id. at 670.
263. See supra note 243.
265. Id. at 16.
266. Id.
267. Id.
268. See id.
269. See id. One prediction describes a market where S&Ls are replaced by mortgage mutual funds as the nation’s leading lenders of residential mortgage money. While these funds may be available at competitively priced interest rates, the investors would retain an equity interest in all mortgages. E. Cox, BANKER’S DESK REFERENCE, 1981 YEARBOOK 33 (1981) (citing Michael Evans, a leading econometrician).
low-rate loans.

Consumers and lenders alike have been caught in what has been described as a "silent revolution" that is providing a sharply different environment for financial institutions in the 1980s. As their own sophistication increases about the rate of return on their personal investments, characterized by greater willingness to shift funds out of passbook accounts for greater yields elsewhere, consumers must also be willing to take a more realistic approach to the investment lending practices of banks and other lending institutions. Judicial intervention on behalf of the consumer in the context of the due-on-sale controversy, except in limited inequitable situations, retards the functioning of the economic market and represents a shortsighted viewpoint inconsistent with the market realities of the 1980s.

VI. A Proposal for State and Federal Uniformity

Although judicial acceptance of the enforceability of the due-on-sale clause in New York is still the general rule, its enforceability and stability may be undermined by the potential for expansion of the limited factual exceptions in Nichols and Silver. Particularly in the area of commercial lending, where New York enjoys national prominence as a financial center, the stability of the due-on-sale clause is necessary to allow lenders to plan long-term investment strategies and execute mortgage contracts which will be upheld, barring evidence of true duress or other unconscionable terms.

Moreover, the evolving era of alternative mortgage instruments need not portend the demise of the fixed-rate mortgage, as this is clearly a reasonable and desirable form of financing a home, par-

270. Ready & Ranelli, supra note 251, at 16.
271. This phenomenon, called "disintermediation," also occurs when depositors fail to deposit funds at all in the traditional "passbook" type accounts, opting instead for higher yields in less traditional accounts or for more disposable income. According to the FHLBB, "Americans withdrew a record $25.5 billion dollars more than they put into savings and loan associations last year [1981]. At the same time, savings and loans—the primary source of home mortgages—closed only $52.1 billion in home loans in 1981, the lowest level since 1974." N.Y. Times, Jan. 29, 1982, at D5, col. 2.
274. 73 A.D.2d 81, 424 N.Y.S.2d 945 (4th Dep't 1980).
275. In fact, two commentators recently examined the FHLBB's and the Office of Comptroller of the Currency's new regulations on alternative mortgage instruments and concluded that "despite the intent of the regulations, the borrower is not well protected from
particularly for homebuyers seeking long-term stability or who anticipate a decline in income in later years. While the use of a fixed-rate mortgage may require a higher cost to the borrower to offset the increased risk to the lender, the due-on-sale clause will help to ensure that fixed-rate mortgages remain an available choice for the homebuyer. As homeowners participate more in arranging the creative financing of their own homes, their own financial self-interest may warrant the use of a due-on-sale clause in their own financing agreements with the purchaser. Likewise, a state bank or savings and loan association’s decision to forego use of the due-on-sale clause in either a fixed-rate or alternative mortgage can then be based on competitively bargained-for terms rather than on its fortuitous location in a state where the clause is in current disfavor.

Preemption by the due-on-sale regulations for FS&Ls, national commercial banks, and federal credit unions appears to be a foregone conclusion,276 at least as to loans made after the effective dates of the applicable regulations.277 Assuming the proposed national legislation278 does not, at the moment, expressly preempt other state-regulated lending institutions, this leaves the due-on-sale clause at the mercy of the state courts or legislatures in several areas: (1) due-on-sale clauses in FS&L mortgages made before June 1976;279 (2) due-on-sale clauses in national bank mortgages made before the effective date of the final regulations now in proposal form;280 (3) due-on-sale clauses used in mortgages made by other lending institutions which are not otherwise covered by current or pending federal legislation;281 (4) due-on-sale clauses used in commercial mortgages outside of the purview of the federal agencies;282 and (5) due-on-sale clause options which may be available to non-institutional private individual or group lenders in either residential or commercial settings.283

The New York legislature should enact a clear law for state-

certain increases and may be ill-advised to utilize these loan instruments in financing the purchase of a single-family home.” Iezman and Hoffman, The Adjustable Rate Mortgage and the Adjustable Mortgage Loan: The Effect of Unlimited Interest Rate Adjustments In Residential Home Loans, 1 Intr’l Prop. Inv. J. 121, 123 (1982).

276. See supra notes 148-49, 158-84 and accompanying text; see infra note 287.
277. See 12 C.F.R. § 545.8-3(g) (1981); supra discussion in notes 158-84.
278. See supra notes 185-91 and accompanying text.
279. See supra notes 131-35, 148-52, 158-70 and accompanying text.
280. See supra notes 168-70 and accompanying text.
281. See, e.g., cases cited supra notes 192-232.
282. See, e.g., supra notes 56-65 and cases cited.
283. Id.
chartered and state supervised lending that will uphold the contractual effect of the due-on-sale clause in lending agreements without requiring its use. This legislation could also provide clearly enumerated equitable exceptions such as those contained in the regulation of the FHLBB. The legislature should adopt a standard of reasonableness as to the consent of the lender for waiver or enforcement of the due-on-sale clause that allows readjustment of interest rates as an acceptable justification for enforcement. This rate change could be tied to certain indices such as the FNMA secondary mortgage index, so that a lender could not demand an interest rate greater than the prevailing market rate.

While section 254-a of the New York Real Property Law impliedly sanctions the use of the due-on-sale clause, it does not do so directly. The section merely precludes a lender’s assessment of a prepayment fee on the borrower when the lender has also denied consent for a new purchaser to assume the existing interest rate. Perhaps this waiver of the prepayment fee could be mandated in situations where the lender does not desire a change in interest rate at transfer, due to a decrease in the prevailing rate, but the purchaser desires to refinance the loan. In that situation, the purchaser will always seek the lower rate and the original borrower will be forced to repay the remaining principal earlier than called for in the loan contract.

While this state capitulation to federal banking practices could be viewed as undermining the dual banking system with a corresponding switch to national regulation, the movement toward nationwide banking markets and deregulation mark some inevitable decline in a bank’s attachment to its home state. The New York legislature can take steps to better protect the interests of all parties to the mortgage agreement—lender, borrower, new purchasers and the public—by more precisely formulated statutes regarding the due-on-sale clause’s use and abuse, and thereby join the growing resolve of federal lenders toward enforceability of due-on-sale clauses. Such legislation, applicable to all state institutional lenders, will avoid a lack of uniformity between the federal and state regulated banking systems.

284. See supra text accompanying notes 106-11.
VII. Conclusion

A misguided preoccupation with consumer protection has moved the judiciary to deal a serious blow to the due-on-sale clause. Well-drafted legislation is the best solution to avoid its demise in New York lending markets. A case-by-case disposition is inefficient and presents too many different situations for a clear and stable rule to emerge from judicial intervention. In order to preserve the stability of the residential and commercial real estate markets, lenders and borrowers must be able to rely on the terms of their mortgage contracts. A borrower should not be permitted to disaffirm the terms of a mortgage contract without a clear showing of fraud or duress.

The use of the due-on-sale clause makes good economic sense, not only in the fixed rate mortgage but in the newer variable rate contracts as well. Those lending institutions that have traditionally provided the funds for home mortgage financing are entering a new era of banking practices that will provide them greater opportunities for investment in non-traditional areas. Unless mortgage lending practices are allowed to keep pace with the economic realities of the 1980s, consumers, naively "protected" by courts and legislatures, will find themselves out in the cold.

Linda L. Kreicher

287. As this note went to press, the United States Supreme Court decided the due-on-sale preemption issue in Fidelity Federal Savings & Loan Association v. de la Cuesta, 50 U.S.L.W. 4916 (U.S. June 29, 1982) (No. 81-750). See supra text accompanying notes 100-44. The Court reversed the California Court of Appeal's holding that Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978), was controlling and that California law was not preempted by the FHLBB's regulations on the subject of due-on-sale clauses. See supra text accompanying notes 23-65.

The Supreme Court, in a 6-2 decision, held in de la Cuesta that the FHLBB's regulation did preempt conflicting state limitations on the use of due-on-sale clauses and, therefore, barred application of the Wellenkamp rule to federal savings and loan associations. Justice Blackmun, writing for the majority, recognized the FHLBB's plenary authority under the Home Owners' Loan Act of 1933, 12 U.S.C. § 1461 (1976 & Supp. IV), to regulate the savings and loan associations in accordance with the "best practices" necessary to protect their financial stability. de la Cuesta, 50 U.S.L.W. at 4921. According to the Court, the Board's decision not to compel use of the due-on-sale clauses in its mortgage agreements did not affect its "unambiguous" intention to preempt state due-on-sale restrictions that undermine the Board's flexibility "to adjust a long-term mortgage's interest rate towards current market rates." Id. at 4919-20. While the Court's preemption decision settles the due-on-sale issue for federal savings and loan associations, it does not impact directly on the due-on-sale restrictions imposed by states on state-chartered lending institutions or on national banks that are regulated by the Comptroller of the Currency. See supra note 6; see supra notes 165-75 and accompanying text. The Court's decision lends further support, however, to this note's argument for statutory authorization of due-on-sale clauses in New York and other states, in order to allow state-chartered lending institutions to remain economically competitive with federal
lenders. Further, legislative endorsement of the due-on-sale clause's use by state-chartered savings and loans (SS&Ls) will help to curtail the SS&Ls' tendency to switch from state to federal charters in order to take advantage of more favorable lending regulations.